<u>25 marker model answer | Economics A Level Edexcel A style</u>

I have written a practice question below with a sample answer. This answer would likely score full marks or close to this.

Here is the question:

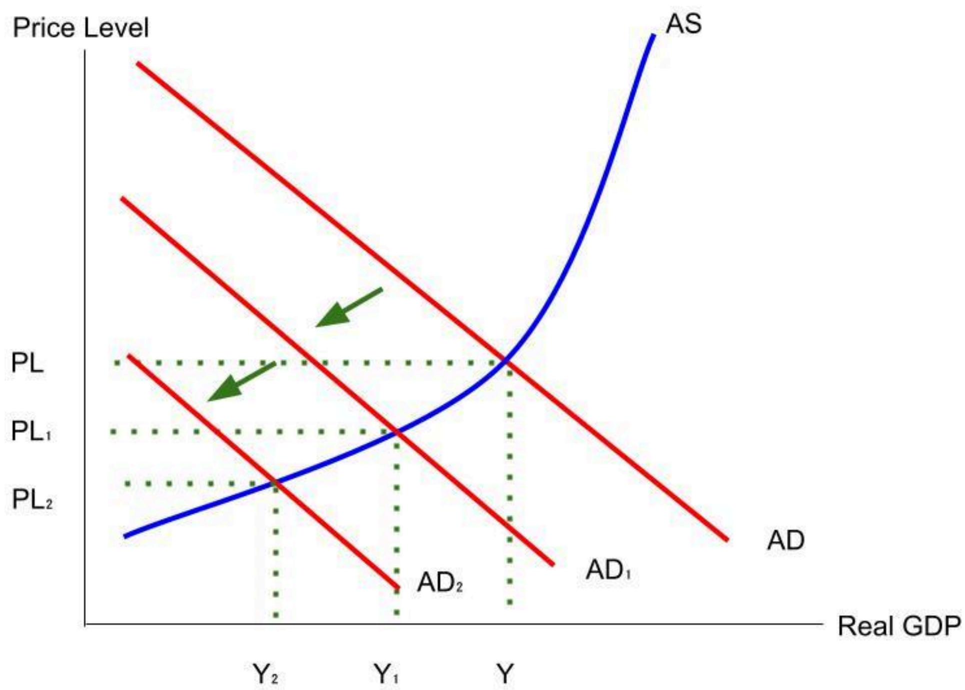
Evaluate the effects of an increase in corporation tax on firms making high profits.

(25 marks)

Here is the model answer:

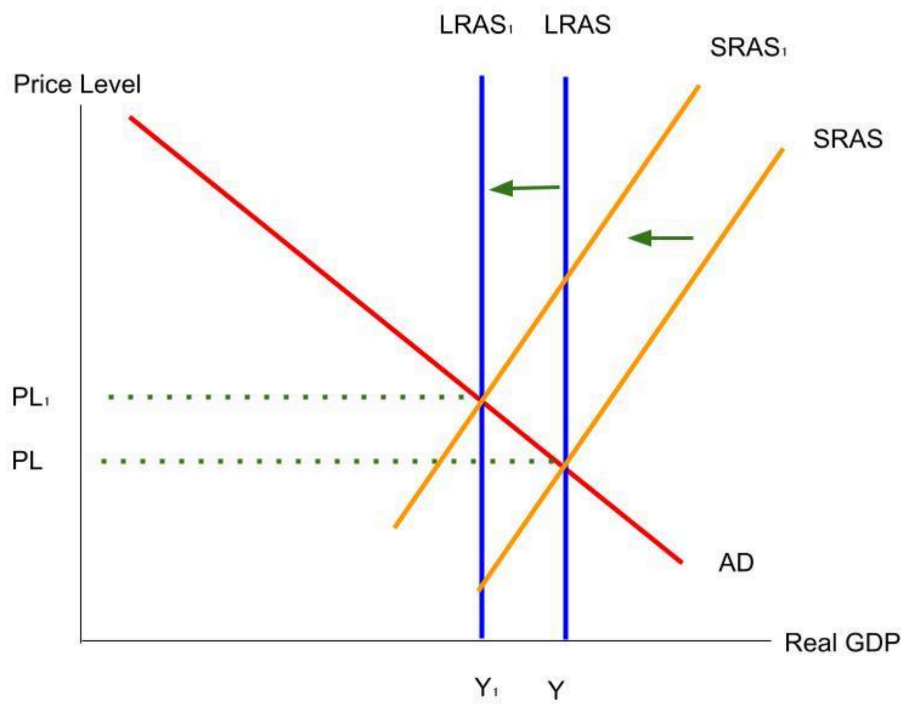
Corporation tax is a tax on firms' profits. Aggregate demand (AD) is the total demand in the economy, AD = C+I+G+X-M. Increasing corporation tax rates "from 19% to 25% for companies with profits above £250,000 per year" reduces the **post-tax profits** of these firms. This leaves reduced funds for investment, so **investment may fall**. Also as firms know any future profits will be taxed at a higher rate, this will disincentivise investment further. This is because firms will have reduced returns (lower post-tax profits) from any new investment. So investment falls and as investment is a component of aggregate demand (AD), **aggregate demand shifts left** from AD to AD1. This may cause a **negative multiplier effect**. This is where an initial fall in investment leads to an even larger fall in AD. Lower investment results in lower incomes for firms and cuts in wages, so consumers cut their spending, meaning consumption also falls and so on. So AD shifts further left to AD2. This results in lower real GDP as real GDP falls from

Y to Y2. Hence corporation tax may lower real GDP, likely resulting in lower living standards.



However this argument depends on the **proportion of AD** influenced by the corporation tax rate rise. Only **firms making larger profits** are facing a corporation tax rise. So firms making lower profits, for example small businesses, are less likely to reduce their investment. Also consumption is the largest component of AD, making up roughly 60% of AD, not investment. So a given percentage fall in investment by larger companies may have only a smaller effect on AD. So real GDP and AD only fall by a little following the rise in corporation tax.

Decreased investment can also influence the supply side of the economy. Lower investment could mean reduced firm spending on capital goods and human capital. So this could reduce **UK productivity** and hence the **productive capacity** of the economy, particularly if investment no longer covers depreciation costs. This means the **LRAS could shift to the left** from LRAS to LRAS1. Higher corporation taxes could mean higher business costs, **shifting the short-run aggregate supply curve left** too, from SRAS to SRAS1. Lower productivity and higher business costs could lead to a higher price level in the UK economy, reducing the competitiveness of the UK as a place to do business and reducing the price competitiveness of UK exports. So there may be fewer businesses choosing to set up in the UK, preferring to set up abroad. The higher price level thus **reduces export demand**. As a result, there is a **contraction along the AD curve**. Real GDP falls from Y to Y1. Productivity for the UK economy is 15% below the average of other G7 economies (as of 2015), so corporate tax rises could further worsen this UK productivity gap with other nations.



However this depends on the level of corporation tax rates in other economies. The UK has the **lowest corporate tax rate** among the G7 economies, even after the tax rise. Hence there may be less incentives to set up a business abroad even after a corporation tax rise. So the effect on competitiveness is reduced. Also many economies have agreed to a **global minimum corporation tax of 15%**, further reducing the risk to competitiveness from raising corporation taxes. So investment is less likely to fall, businesses are less likely to relocate and so productivity growth is less likely to slow. While the corporation tax rate rise may reduce investment, it is less likely to have a significant impact on international competitiveness.

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Overall raising corporation tax on firms making high profits is likely to be **effective in raising revenue**. While raising corporation tax will reduce aggregate demand and aggregate supply, by raising taxes only on higher-profit firms, the impact is limited. The impact of the corporation tax rate rise on AD does depend on the size of the multiplier. The formula for the multiplier is $\frac{1}{MPS+MPT+MPI}$. With the tax burden rising as a percentage of GDP in the UK due to the freeze of the personal allowance income tax band at £12,570, dragging more people into higher tax bands, the marginal propensity for tax is rising. Similarly the UK is a net importer particularly in goods, suggesting a high marginal propensity to import. These factors lower the size of the multiplier for the UK. So a fall in investment, due to corporation tax rate rises, is likely only to have a small additional effect on AD and real GDP.

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